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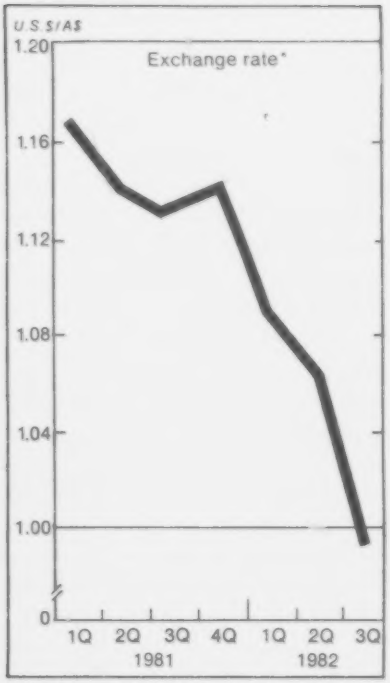
Behind the Troubled Australian Dollar

The Australian dollar has continued to slip against the major currencies, and last month fell below parity with the U.S. dollar. Parity carries no special economic significance, of course. But the sinking through the parity threshold does have a certain psychological significance that draws attention to some of the underlying problems of the Australian economy.

Not long ago it was widely accepted that Australia enjoyed highly favorable economic prospects for the 1980s. Well-endowed by nature, the country was experiencing a resource-based boom. Given its dependence on foreign trade, however, it was inevitable that Australia eventually would feel the international recession. Non-farm GDP has been declining and unemployment is approaching 7%—quite high by Australian standards.

The value of the Australian dollar



* Weekly average of daily figures at mid-quarter.

At the root of Australia's problems is the world's changing inflation environment. Over the past decade, as inflation accelerated worldwide, investors sought refuge in tangible assets. As a consequence, resource prices rose even faster than the general price level, and as the owner of vast mineral deposits, Australia was a beneficiary of this process. However, tighter monetary policies and the tempering of inflation expectations elsewhere have resulted in a relative shift in asset preferences away from real wealth. Current and expected future resource prices have collapsed, leading to the cancellation or postponement of a number of Australian investment proposals.

In addition, Australia's rate of inflation has remained stubbornly high, compared with the inflation rates of its major trading partners, and shows no signs of coming down soon. While inflation for the United States and for Japan is forecast to fall in 1982 to annual rates of less than 6% and 3%, respectively, Australian inflation is expected to be about 10.5%.

As elsewhere, inflation "down under" is a monetary phenomenon. But the reasons for Australia's monetary excesses are predominantly political. By accommodating the high wage settlements advanced by Australia's strong and militant labor unions, the monetary authorities have exceeded their monetary targets in each of the past four years.

Australia is now facing an unpleasant choice. To avoid chronic Australian dollar weakness, it must accept the unpalatable side effects of disinflation. The U.S. solution—tight money—would control inflation and ultimately, as unemployment rose, would moderate union demands. Britain's experience shows, however, that with militant labor unions the adjustment process is long and painful. Such a policy would require patience from the Australian people and tenacity from their political leaders.

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Latin America: devaluations proliferate.

Foreign-exchange devaluations have speeded up in Latin America during the past two weeks. On the evening of August 5, *Mexico* devalued the peso once again and set up a two-tier—official and floating-rate—system. As of last Wednesday, the floating peso was trading at 75-82 pesos per U.S. dollar—a depreciation of roughly two-thirds from the rate before the February devaluation. Almost coincident with the Mexican devaluation, *Chile* allowed its peso to float, with the rate reaching around 59 to the dollar last Wednesday. Compared with the three-year fixed rate of 39 pesos that Chile had maintained since 1979, the peso has now lost about one-third of its U.S. dollar value. These latest moves represent significant shifts in the foreign-exchange rate systems of Mexico and Chile. They followed equally large exchange-system changes initiated in *Argentina* last month, toward a multiple-rate and floating regime. The exchange movements in these three key countries underscores what is becoming more evident for most of Latin America—that in circumstances of significant uncertainties in monetary policy and world economic activity, maintenance of fixed or pre-announced exchange-rate systems can be the prelude to losses of confidence and to capital flight.

Denmark's recovery may be accompanied by payments problems, rekindled inflation.

The Danish economy continues to show signs of recovery, and the Nordic countries' industrial federations have just issued a report projecting a 2.5% rise in Denmark's real output this year and 3% in 1983. The EMS realignments provided some stimulus: The kroner was devalued by a general 3% in February and then taken down by a further 4.25% against the DM in June, giving a boost to export competitiveness. The government now expects that unemployment will fall from its current rate of 9.5% to about 8% by the end of 1983. This improvement, however, will not be without cost. Despite the devaluations, the 1982 balance-of-payments deficit is likely to exceed last year's $1.7-billion figure, and 1983 is expected to bring only marginal improvement. In addition, wholesale prices have begun to rise again. And consumer prices are expected to post a 9.5% increase this year, on the heels of an 11.7% rise in 1981.

Dismal fish catch takes Icelandic economy to the depths.

Iceland's National Economic Institute has just produced one of its gloomiest forecasts ever. The main reason is a drastically reduced catch of cod and capelin. Fisheries production—which accounts for a large part of Iceland's GDP—is expected to be down between 12% and 20% in 1982 compared with last year. To make matters worse, the aluminum and ferro silicon industries have been hit by the depressed level of world economic activity. As a result, GNP is now expected to decline by at least 3% during the current year. Moreover, falling Icelandic export earnings are likely to take the current-account deficit to some 8% of GNP, compared with 5% in 1981. This comes as something of a setback for the small Icelandic population, but hope remains that the poor performance is only cyclical and that 1983 will see an improvement.

Norwegian trade deficit expected to be short-lived.

As expected, Norway's balance of trade swung into deficit in June—the first deficit since 1979. The trade gap reflects not only the reduced prices of oil exports, but also the weakening volumes of non-oil exports that have resulted from continued cost pressures in the domestic labor market. Overall, domestic inflation has been running at about 8.5% this year. At the same time, however, the kroner has remained strong on the foreign-exchange markets, so the competitiveness of Norwegian exports has been reduced. Part of the reason for the kroner strength has been the 25% weight given to the dollar in the basket of currencies used by the central bank of Norway in its stabilizing actions. Effective August 2, however, the central bank reduced the dollar weight to 11%. As a result, the kroner has since depreciated by about 2% against most currencies. Despite the June trade deficit, a balance-of-payments surplus of some $800 million is expected this year, rising to some $1.5 billion in 1983. Inflation is expected to continue to moderate. And economic growth, which has faltered in recent months, is forecast to pick up later this year.

Honduran economy hard hit by Central American political tensions.

Honduras is suffering from the spillover of widespread political tension in its neighboring Central American countries. Trade flows and tourism have been stifled, both local and foreign investor confidence has been badly shaken, and substantial capital flight has occurred. In addition, prices for Honduras' principal exports have remained soft in the face of high international interest rates and petroleum prices. As a result, the country's international payments situation has steadily worsened, and real GDP in 1981 posted virtually no growth following an increase of only 2.6% in 1980. Barring an improvement in the political situation in the rest of Central America, Honduras' economic activity is expected to decline still further. Discussions are currently under way for a new standby loan from the IMF and for rescheduling a major portion of the $270-million public debt owed to foreign commercial banks. This, as well as the level of multilateral and bilateral financial assistance and the extent to which the acceleration of capital flight can be contained, will determine whether further international payments deterioration can be prevented.

Thai trade gap down sharply owing to devaluation, domestic slowdown.

Thailand's trade deficit fell sharply in the first six months of 1982 to $595 million—down from $1.42 billion for the comparable period a year earlier. Despite the continuation of depressed prices for rice, rubber, tin, and other Thai commodities, exports rose over 17%, with some boost to manufactured goods undoubtedly provided by last year's devaluation. Another major contributor to the dramatic narrowing of the trade gap, however, was a 5% drop in imports that stemmed both from the devaluation and from a slowdown in the domestic economy. The central bank now projects that the trade deficit for 1982 as a whole will shrink at least to $2.1 billion from $3 billion in 1981, even if imports pick up considerably in the second half of the year. And in view of the slower domestic activity, the central bank has pared its estimate of 1982 real economic growth to 5.7%, substantially lower than the 7.6% growth realized in 1981.

The New Zealand budget: few unanticipated changes in economic policy.

The New Zealand government's fiscal 1982/83 budget—finally released on August 5—contained few surprises. New Zealand is currently experiencing 17% inflation, and real GDP is expected to grow by only 1% this fiscal year. After Prime Minister Muldoon responded to these problems with the imposition of a one-year wage and price freeze on June 22, the budget announcement had been widely anticipated as a barometer of future economic policy. The document indicates few unexpected changes. As promised, Muldoon reduced income taxes substantially. However, duties on luxuries, such as alcohol and tobacco, and on fuel will be increased. The government forecasts that overall receipts will rise by 16%. At the same time, expenditures are expected to go up by 14%, leaving the projected deficit equal to 5.9% of GDP—down from 6.4% in fiscal 1981/82. There is little in the new budget to encourage those who had hoped for a reduction in New Zealand's high tariffs. Furthermore, Muldoon's recent comments suggest that some of the wage and price controls may be continued beyond next June.

Oil glut pushing Algerian current account into deficit.

Algeria, as a producer of high quality "sweet" crude oil, has inevitably been affected by the current oil glut. But the adverse impact, to date, has been less than other producing nations have suffered. Oil output last year fell to an average of 800,000 bd from 1 million bd in 1980. Nevertheless, hydrocarbon revenues are estimated to have increased slightly in 1981 because of higher exports of condensate, LNG, and LPG. The early months of 1982 have been more difficult, with oil production reportedly down to about 600,000 bd. However, an advantageous deal was struck in March with the French government: premium prices for Algerian LNG exports in exchange for a commitment to award $2 billion in contracts to French companies. Still, gas exports remain uncertain. In particular, negotiations are under way with Italy over the price of natural gas to be delivered through the now-completed Trans-Med Pipeline. Consequently, Algeria's current account—after recording modest surpluses in both 1980 and 1981—is expected to move back into a deficit of about $1.5 billion in 1982.

Consumers Hold Key to Economic Recovery

Despite the turnaround in real GNP in the second quarter, there is considerable evidence that many sectors of the economy are still extremely weak. Latest data indicate that business investment is still declining and that inventories are still being liquidated. Factory orders fell in June, and industrial production is almost certain to have registered another drop in July. Given the level of interest rates, the strength of the dollar, and deficit worries in Washington, neither housing, exports, nor government is likely to lead a recovery. And it seems unlikely that consumer spending will rise enough to boost real growth to the nearly 4% annual rate now forecast by a consensus of economists for the remainder of 1982.

Recent evidence on the consumer sector is not encouraging. Retail sales rose by only 1% in July, despite a 2% increase in disposable income from the personal income tax cut and the cost-of-living adjustment to Social Security checks. Furthermore, this modest rise in sales followed a huge 3.3% decline in June. Continued increases in unemployment, still-high interest rates, and cautious consumer attitudes toward the use of credit are chiefly responsible for the relatively meager sales increase compared with the rise in income. There may be some carry-over retail sales gains in August and September, especially from salaried workers who only received the cut in taxes in their end-of-month paychecks. But this time around, any significant increases in consumer spending are likely to be short-lived.

Worries over the outlook for fiscal policy may also be contributing to consumers' reluctance to spend. Congress is currently considering a tax bill that would raise individual taxes nearly $10 billion in fiscal 1983, taking back about one-fourth of the recent gain in disposable income. Moreover, some recent congressional estimates now place the deficit at about $150 billion for the next several years. Individuals may reason that such large deficits will place upward pressure on interest rates, keeping many sectors of the economy depressed and leading to increased precautionary saving. Furthermore, if the public's expectations about future deficits have also been revised upwards, then consumers may increase their savings to pay the higher expected future tax liabilities arising from the interest on the additional debt.

Both the Federal Reserve and the Reagan administration have contended that current fiscal and monetary policies will foster a moderate, consumer-led recovery. But policymakers are also counting on consumers to increase savings, in order to fund higher investment and rising government deficits. Unfortunately, consumers cannot take the lead in both directions simultaneously.

Douglas L. Bendt

Asia and Oceania — Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE				
			6 months ending	12-month change	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	u c lion
Asia	Bangladesh	Budget for fiscal 1982-83 imposes new taxes and raises petroleum and other prices sharply.	March	— 4%	11.6*	126	June	105	— 55%	0.5	
	Burma	Growth targeted at 6% for FY 1982-83 but could be lower.	Jan.	— 3%	5.3*	146	June	155	— 47%	5.8	
	China, People's Republic	Strong domestic growth forecast owing to recovery in heavy industry and good harvest prospects.	June	+10%	260.0	260	April	6,077	+136%	3.3	
	Hong Kong	Financial Secretary Bremridge lowers forecasts for fiscal year: real GDP growth 6%, inflation 11%.	Nov.	+23%	24.3	4,710	n. a.	—	—	—	
	India	Aid consortium pledged $3.66 billion in new commitments for fiscal 1982-83.	March	—17%	161.4*	236	March	4,461	— 35%	4.1	1.
	Indonesia	Declining revenues force a slowdown in government spending.	Dec.	+ 3%	77.5	500	March	5,235	— 15%	4.5	
	Japan	Fiscal stimulus package to be considered in September.	May	— 2%	1,129.6	9,684	June	25,431	— 7%	2.1	
	Korea	Curb market scandal does not mar outlook; slow steady recovery.	May	+ 6%	63.4	1,638	June	2,556	+ 5%	1.2	1.
	Malaysia	Government pledges 14% cut in 1982 expenditures, lowers real growth forecast to 5%.	March	— 9%	23.6	1,638	April	3,647	— 9%	3.7	
	Pakistan	Budget for fiscal 1982-83 imposes 5% import surcharge, 5% tax on domestic oil production.	April	—29%	31.2*	364	June	809	— 24%	1.9	
	Philippines	Government announces subsidy for hard-hit copper producers.	Dec.	—10%	38.6	780	June	2,002	— 12%	2.8	
	Singapore	Tight labor market means wages will rise faster than 4%-5% inflation.	May	+ 4%	11.6	4,780	March	7,360	+ 8%	3.0	
	Sri Lanka	Real growth could slow to around 4% in 1982 because of drought.	Jan.	0	4.4	291	June	234	+ 6%	1.8	
	Taiwan	Wages flat and unemployment increasing.	Dec.	+17%	45.5	2,530	Jan.	7,683	+219%	4.7	
	Thailand	Government pares 1982 growth estimate further to 5.7%.	March	+ 5%	36.1	750	June	1,514	+ 6%	2.0	
Oceania	Australia	Rising unemployment foreshadows less labor militancy; inflation still a problem.	June	— 2%	156.0	10,500	May	3,895	+ 36%	1.8	
	New Zealand	Wage-price freeze may hide inflation, but will not eliminate it.	April	— 4%	24.4*	7,858	June	339	— 3%	0.7	
	Papua New Guinea	Government practices austerity; public spending to fall 3% this year in real terms.	Dec.	—15%	2.6**	838	June	257	— 11%	n. a.	

*Fiscal year **1980

Upgrading Corporate Balance Sheets

The recent decline in bond yields has prompted many firms to take steps to improve their balance sheets, either through the lengthening of maturity structures or through the reduction of overall debt ratios. The market's continued uncertainty over whether the bond rally will be sustainable, however, has spawned some unusual new means of doing so.

For example, to reduce their dependence on short-term liabilities, firms have found it necessary to employ such innovative long-term financial instruments as bonds with warrants attached and extendable notes. The bonds with warrants entitle investors to buy more bonds at a fixed coupon rate within a stated number of years. Several of these issues were floated earlier this month, indicating that issuers believe the recent rate decline will be only temporary. But since the warrants are only valuable if interest rates fall, the market's acceptance of these issues at yields lower than those of straight debt issues of comparable maturity reflects investors' sentiments that interest rates may fall still further. With the extendable notes, corporate issuers are able to satisfy investor demands for short-term instruments, while retaining the option to lengthen the maturity of the debt at a pre-designated point in time. There has been a rash of these issues over the past month—also with yields below comparable straight debt.

As a means of lowering firms' overall debt ratios, debt repurchases have gained in popularity since 1979—primarily because the general rise in interest rates has enabled firms to buy back outstanding issues at a profit. More and more, however, this practice has been limited by the lack of a viable source of funds: Additional debt raises financing costs with no improvement in leverage, while new equity dilutes current stockholders' positions, and retained earnings lower liquidity and force the gain to be taxed as ordinary income.

As an alternative to debt repurchases, over the past few months firms have increasingly relied on "defeasance" to reduce their overall debt ratios. Through this practice, a company assigns its debt obligations and a sufficient quantity of government securities to a trustee, who then uses the revenue from the securities to pay the principal and interest on the debt as they come due. The result is that the firm reduces its leverage, saves interest expense, and records a capital gain on the debt which is taxed at a lower rate than ordinary income.

It is still too early to conclude whether these developments will continue—bringing significant improvements in corporate financial structures—or whether the current "window" in the bond market will be closed by an excess supply of new issues. If the latter proves to be the case, some of the recent financial innovations may become permanent fixtures in corporate financial strategies.

Carl Alan Batlin

OF PAYMENTS		MONEY AND BANKING						COUNTRIES
		12-month changes						
se of IMF redit, mil- s of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars August 11, 1982	change from year earlier	current monetary conditions
362	IMF Extended Fund Facility arrangement formally cancelled.	April	+13%	March	+ 7%	.0625	— 1%	No 1982-83 bank borrowing for deficit financing planned.	Bangladesh
50	Aid donors' recent pledges of assistance near last year's level.	Jan.	+ 2%	Apr.'81	+13%	.1320	— 2%	Inflation remains low.	Burma
492	Jan.-June trade surplus was $2.4 billion; import restrictions continue.	Dec.	+ 3%	March	+16%	.5192	— 9%	Increased personal saving boosts housing construction.	China, People's Republic
—	Trade deficit appears to be improving compared with 1981.	Nov.	+17%	Nov.	— 1%	.1637	— 6%	Credit demand soft; rates may fall modestly.	Hong Kong
274	Refunds of excise and customs duties on exports expanded.	April	+ 8%	Jan.	+11%	.1035	— 8%	Credit restraint eased slightly.	India
0	Trade account depends on oil prices and OPEC quota.	April	+ 9%	March	+29%	.0015	— 6%	Money is tight and interest rates high.	Indonesia
0	No clear signs of export pick-up but imports remain sluggish.	June	+ 2%	May	+ 2%	.003799	—10%	Long-term prime, bank debenture rates may be raised.	Japan
264	Foreign demand depressed; improved trade gap depends on curbing imports.	June	+ 5%	March	+ 3%	.00145	— 3%	Financial reforms may make credit tight for some.	Korea
271	Tin producers' association formed with Indonesia and Thailand.	May	+ 6%	April	+ 8%	.4231	0	Mammoth $1 billion commercial bank loan undertaken.	Malaysia
993	New import liberalization steps include removal of protection for yarn industry.	April	+10%	April	+ 8%	.0920	—10%	Reserve outflow held FY 1981-82 M2 growth to 12%-13%.	Pakistan
868	Aid group pledges $1.2 billion in development assistance for 1983.	Jan.	+18%	April	+ 4%	.1120	—14%	New deposit rule creates captive market for securities.	Philippines
0	Trade deficit will probably widen.	April	+ 5%	March	+14%	.4605	— 1%	Government may move to slow entry of new banks.	Singapore
359	Aid consortium pledges $668 million in assistance this year.	April	+13%	March	+15%	.0495	—15%	Money growth, inflation likely to reaccelerate this year.	Sri Lanka
0	Trade surplus probable in 1982 as imports fall.	Jan.	+ 9%	Jan.	+11%	.0280	— 3%	Credit conditions improving; rates may decline.	Taiwan
653	Jan.-June trade deficit narrowed sharply with drop in imports.	May	+ 5%	Dec.	+ 2%	.0450	— 5%	Consumer-price inflation of 7% expected in 1982.	Thailand
0	Capital inflows continue, offsetting current-account deficits.	March	+11%	April	+ 2%	.9795	—14%	Money growth above target for fourth year in row.	Australia
17	Current-account deficit widens.	March	+16%	Feb.	+ 7%	.7285	—12%	Interest rates frozen, credit will be tight.	New Zealand
49	Trade balance deteriorates owing to low world commodity prices.	Dec.	+ 6%	April	— 9%	1.3500	n. a.	Government raises commercial bank lending target by 11%.	Papua New Guinea

World Interest Rates

market rates as of Aug. 11, 1982; bond yields as of Aug. 6, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	15.20	11.50 intervention rate	13.50	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	10.875 August 12	18.50	11.875	9.00	14.50	9.00	19.75	9.50	2.00 1-month Euro-Swiss fr. rate	7.4375
Treasury Bills 91-day, Middle Rates	9.92	14.95	11.00	14.25	15.63 1 year	n. a.	17.40 7th days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	11.50 finance paper discount basis	15.40 finance paper 15% tax w/h	10.515	13.40 Certified	14.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.35	15.30 15% tax w/h	11.00	13.40 Certified	not traded	9.40	21.10	no market	4.625	no market
Government Bonds Long-term, new and old issues, average yield	13.46	15.68	12.58	10.384 20% tax w/h	15.31	9.15	20.48	10.30	4.85	8.102
Industrial Bonds prime, long-term, new and old issues, average yield	15.30 As Industrials	16.17	13.86	14.013	16.45	9.26	20.25	11.35	5.90	6.50
Bank Short-Term Rate to Best Borrowers (prime rate)	15.00	17.00	12.50	17.25	16.60	12.00	21.75 ½ qtrly fee on outstdng	10.50	9.00	6.00
Bank Time Deposits 3-month	11.375 Cert. of Dep.	15.40	11.375	14.15	14.50	9.10	11.50	9.375 large deposits	3.50 residents only	3.75
Eurocurrencies 3-month, asked	12.875	16.00	11.50	no market	17.00	9.125	no market	9.375	4.375	7.5625
Exchange Rates—in U.S.$ rates floating against the $	—	.7983	1.6965	.02075	.1425	.3964	.000711	.3600	.4642	.003796
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.157 *D*	1.415 *P*	1.234 *D*	4.211 *D*	3.834 *P*	7.314 *D*	3.556 *P*	8.789 *P*	5.585 *P*

Eurodollar Deposits
(London, interbank, bid)
August 12

7-day	11.1875
1-month	11.5625
3-month	12.5625
6-month	13.50

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.344
U.S.-Canada Treasury Bills	−1.138
U.S.-Canada Finance Co. Paper	−0.532
Eurodollars-U.K. Local Auth. Deposits	+0.148

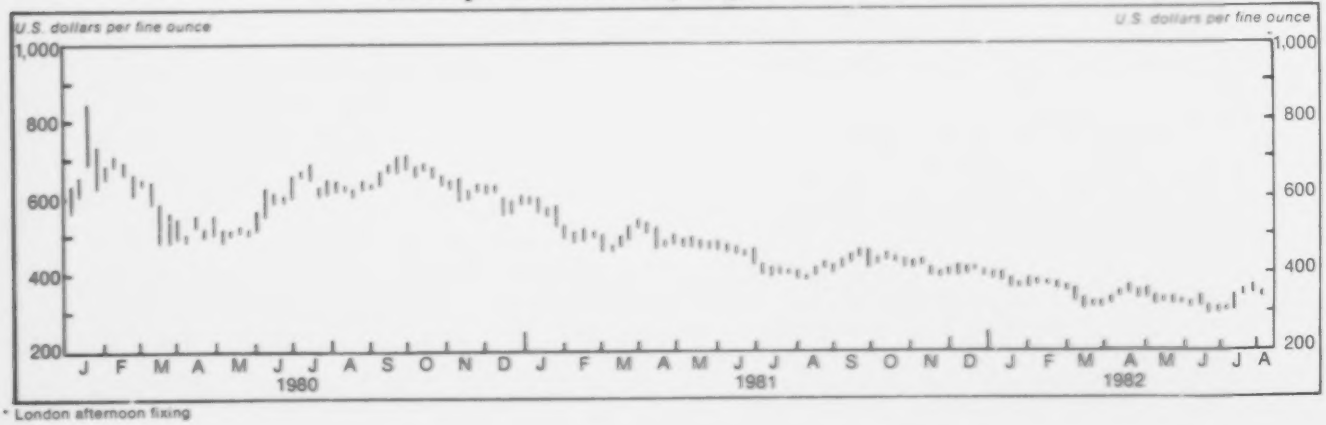
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.00
Over 7 yrs.	14.75
DM Bonds	
7 yrs. and under	9.125
Over 7 yrs.	9.25

Gold Price
London afternoon fixing
333.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Gold prices: weekly highs and lows*


U.S. dollars per fine ounce
U.S. dollars per fine ounce
1,000
800
600
400
200
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A
1980
1981
1982

* London afternoon fixing

What Drives the Golden Chariot

The price of gold has fallen back somewhat in the past two weeks, after a month-long rally that took it from just under $300 per ounce in late June to well over $360 toward the end of July (see chart, page 6). Although analysts seem to agree that the latest price gyrations can be attributed largely to movements of U.S. interest rates, they disagree sharply over such fundamental questions as what forces move gold prices over the longer term, whether the recent retreat will continue, and how far it will go. To a large extent, these disputes reflect a conflict over the proper approach to forecasting gold-price swings.

One prevalent method is to analyze flows of new supply and demand to the market (see table below). For example, Western production figures receive considerable attention. And some observers point to Soviet gold sales and to official purchases and sales of gold as prime movers of gold prices. There is little evidence, however, that these flows have had any discernible effects on gold prices over the long run. To the contrary, non-Communist mine output has remained remarkably stable over the years, even as the gold price has fluctuated dramatically. And Communist-bloc sales to the West during 1980 and 1981—years that witnessed a sharply *falling* trend in gold prices—averaged well below the levels of such sales during the late 1970s, when the price of gold trended sharply upward. As for "official" institutions, governments and central banks were large net *buyers* of gold during the price slump of 1980-81, after several years as net sellers while gold prices were rising.

In fact, the analysis of supply and demand flows offers little help in the case of a highly durable commodity such as gold. These flows are overwhelmed by even small adjustments in the "stock" demand for *holding* gold relative to the *existing* supply of above-ground gold. Investors will be just willing to hold the entire stock only at a price that balances it with the stock demand, which reflects the relative attractiveness of gold as an asset in the portfolios of central banks, private institutions, and individuals. Gold flows can be considered an equilibrating mechanism; purchases and sales reflect differences of opinion among market participants over the determinants of—and the price that will balance—stock demand and supply.

This has led some analysts to the view that gold-price movements result primarily from such influences as interest rates and political tensions—which affect the desirability of holding gold and thus can lead to portfolio adjustments by asset holders. To be sure, these forces have often caused temporary shifts in stock demand; but they do not appear to have had a lasting effect. For example, recent political tensions have elicited a much milder—and briefer—reaction than those of a few years ago, as investors have gained experience. And while falling short-term U.S. interest rates undoubtedly influenced the July gold rally, the effect appears to have been transitory; the gold price is now well below its level at the end of 1981, even though short-term rates have fallen about three percentage points from their year-end levels.

A more reliable influence on the stock demand for gold—and thus a promising key to future gold-price movements—is the state of general inflation expectations. There is good reason to believe that anticipations of future U.S. inflation, on average, are now well above the current rate of inflation. This suggests that if the markets ever decide that low inflation is here to stay, expectations will converge toward the current moderate rate of increase of the overall U.S. price level, leading to a further sharp reduction in the price of gold. On the other hand, signs of a more accommodative monetary policy could confirm the markets' worse fears of reaccelerating inflation and send the gold price soaring once again.

Ronald A. Krieger

GOLD FLOWS

	Components of Supply (metric tons)				Components of Demand (metric tons)					
						Total fabrication				
	Non-Communist mine output	Net trade with Communist bloc	Net official sales (purchases)	Total		Carat jewelry	Official coins	Other	Net private bullion purchases (sales)	Total
1972	1,182	213	(151)	**1,244**	**1972**	999	63	283	(101)	**1,244**
1973	1,116	275	6	**1,397**	**1973**	518	54	288	537	**1,397**
1974	1,005	220	20	**1,245**	**1974**	224	287	224	510	**1,245**
1975	953	149	9	**1,111**	**1975**	523	251	209	128	**1,111**
1976	969	412	58	**1,439**	**1976**	935	182	267	55	**1,439**
1977	970	401	269	**1,640**	**1977**	1,003	142	275	220	**1,640**
1978	975	410	362	**1,747**	**1978**	1,008	287	308	144	**1,747**
1979	960	199	544	**1,703**	**1979**	738	290	296	379	**1,703**
1980	946	90	(230)	**806**	**1980**	123	185	234	264	**806**
1981	962	283	(260)	**985**	**1981**	594	201	241	(51)	**985**

Data: Consolidated Gold Fields Ltd.

Gold Standard or 'Real Standard'?

The failure of long-term U.S. interest rates to decline in the face of substantial improvement in U.S. inflation suggests that market participants are extremely uncertain regarding the longer-run outlook for inflation. Indeed, the debt market's continued skepticism regarding Federal Reserve policy is in substantial risk of thwarting a U.S. recovery and prolonging the worldwide downturn in real economic activity.

The Fed is faced with an apparent dilemma: It is "damned if it does" loosen up (long-term interest rates may increase for fears of renewed inflation) and "damned if it doesn't" (long-term rates may remain inordinately high). However, this dilemma is probably the result of considering too restrictive a set of policy options. An alternative proposal—which departs from the usual menu of monetary policy choices—is the "real standard" of monetary control: central bank convertibility into fully indexed government debt.

The real standard is motivated by the serious concerns of current advocates of the gold standard—to provide a rule to eliminate both inflation and the volatility in world financial markets. However, while the gold standard is an antiquated option, not suited for today's sophisticated financial environment, the real standard *depends* on the sophistication of today's markets. It consists of two parts: The first is full indexation, requiring that both interest payments and principal of government debt grow according to the rate of inflation. The second consists of a monetary rule requiring the central bank to maintain convertibility of its liabilities (paper money and commercial bank reserves) into the indexed debt–that is, a requirement that the central bank "peg" the market price of the indexed debt.

Debt indexation is not a novel idea, nor is central-bank market intervention in debt markets to fix the market price of *non*-indexed debt. However, intervention to fix the market price of fully indexed debt not only is novel but also has far-reaching implications.

First, by full indexation of government debt, bondholders would be guaranteed that the interest payments and principal would not be eroded by inflation—thereby eliminating inflation uncertainty in the government securities markets. To the extent that long-term interest rates now reflect this uncertainty, these rates would decline, perhaps substantially.

Second, by requiring the central bank to maintain convertibility into indexed debt, the monetary authorities would be prevented from running monetary policy at their own discretion. Therefore, monetary policy uncertainty would be eliminated, sharply reducing financial and foreign exchange market volatility.

Third, convertibility into indexed debt links the market interest rate on that debt directly with the price level. As a result, the central bank would be unable to follow an inflationary policy. For example, if the monetary authorities attempted to pursue expansionary measures, thereby putting upward pressure on prices, the market would respond by raising the interest rate on indexed debt. As a consequence of the rise in the interest rate on the debt, bondholders would increase their demand for the indexed debt, and, because of the convertibility arrangement, the central bank would be forced to sell them the bonds they desired. However, the sale of the indexed debt would retire money, thus putting *downward* pressure on prices. This adjustment would proceed until *all* of the excess money originally issued had been retired–that is, until the initial inflationary policy was thwarted.

Government officials are currently studying fundamental changes in the institutional environment of fiscal policy, including such devices as the proposed Balanced Budget Amendment and the uniform income tax rate. Perhaps the range of alternatives available for the conduct of monetary policy should also be extended to include serious consideration of monetary discipline through the real standard. *W. Dayle Nattress*

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	IIQ/81	IIIQ/81	IVQ/81	IQ/82	1979	1980	1981
Gross Size (Claims)	1,347.0	1,423.6	1,542.4	1,556.3	1,111.0	1,321.9	1,542.4
Net Size (Claims)	825.0	875.0	940.0	945.0	665.0	810.0	940.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	286.0	292.8	303.7	303.7	269.7	287.5	303.7
Liabilities to Private Nonbank Foreigners	83.6	90.6	94.3	96.9	65.9	75.0	94.3
Total Claims on Foreigners	405.9	421.7	444.9	456.4	324.2	385.4	444.9
Claims on Foreign Public Borrowers	50.7	54.9	59.1	59.8	42.0	48.9	59.1
Claims on Foreign Private Nonbank Borrowers	145.3	148.6	161.4	162.6	117.8	139.9	161.4

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.